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DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 99-0365 RST
Sales/Use Tax — Vehicle Lease Transactions
Tax Administration — Negligence Penalty
For Tax Periods: 1996 through 1997

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ISSUES

I. Sales/Use Tax — Vehicle Lease Transactions

Authority: IC 6-2.5-1-5; IC 6-2.5-1-6(a); IC 6-8.1-3-3.5; IC 4-22-2-24;
IC 6-2.5-5-38.2
45 IAC 2.2-4-27(c); 45 IAC 2.2-1-1(j)
Information Bulletin #28

Taxpayer protests the assessment of Indiana sales tax on the trade-in allowances given to its customers in lease transactions.

II. Tax Administration — Negligence Penalty

Authority: IC 6-8.1-10-2.1
45 IAC 15-11-2

Taxpayer protests the imposition of a ten-percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer, an automobile dealership, sells and services new and used vehicles. Taxpayer also negotiates vehicle leases with its customers. Audit and taxpayer are in disagreement as to the amount of sales tax that should have been collected by taxpayer in these vehicle leasing arrangements.

I. Sales/Use Tax — Vehicle Lease Transactions

DISCUSSION

As part of its vehicle leasing business, taxpayer negotiates lease agreements with its customers. In arriving at the selling price of a leased vehicle, the final cost to the customer is partially offset by any capital cost reductions (down payments). These down payments usually represent cash tendered, manufacture's rebates, and trade-in allowances. Taxpayer collected sales tax on the cash tendered and on the value of the manufacturer's rebates. Taxpayer, however, did not collect sales tax on the trade-in allowances.

Audit concluded that taxpayer should have collected and remitted sales tax on the trade-in allowances. Audit relies on 45 IAC 2.2-4-27(c) which states that "the gross receipts from renting or leasing tangible personal property are subject to tax." Audit reasons that since the trade-in value of the customer's vehicle was consideration given to the taxpayer, and was included in the down payment on the lease agreement, the trade-in allowance was subject to Indiana's gross retail tax (sales tax).

Taxpayer disagreed with Audit's proposed assessments and advances two arguments in support of its protest.

(1) The "trade-in" of an owned vehicle for a leased vehicle should be exempt from taxation as a "like kind exchange."

Taxpayer asserts that since trade-in allowances are exempt from sales tax in *purchase transactions* - as like kind exchanges - trade-in allowances should also be exempt in *lease transactions*. From taxpayer's perspective, there are no substantive differences between a lease and purchase that would effect the method of taxing down payments.

Taxpayer indicates that it has relied on Information Bulletin #28, *Sales/Use Tax: Motor Vehicle Sales and Repairs*, for guidance regarding the taxation of trade-in allowances. Specifically, taxpayer refers to the following language:

> [T]he selling price upon which the tax will be based will be the actual consideration tendered for the vehicle *after deducting all appropriate discounts and trade-in allowance*. The deduction for trade-in allowance applies only to vehicles traded in, and does not apply to other property either personal or real, which is traded for a vehicle. (Emphasis added).

Taxpayer notes that this treatment is consistent with the generally accepted practice of treating exchanges of like kind properties as non-taxable transactions. As an illustration of this proposition, taxpayer alludes to Rule 45 IAC 2.2-1-1(j), which states:

> Non-taxability extends only to the amount of value of the [like kind] property received. Any additional consideration, commonly know as "boot" received either in cash or property of unlike kind must be reported for taxation at actual value. However, when any property is clearly used as a medium of exchange in lieu of cash, the element of taxable exchange will be present.

Taxpayer points out that prior to July 1, 1997, there did not exist any statutory or regulatory language explaining the concept of “like kind exchange” as it applied to vehicle lease transactions. This lack of explanatory language led taxpayer to believe that its interpretation of the like kind exchange concept was consistent with Indiana law.

As taxpayer properly observes, the value received in a like kind exchange is not considered to be gross retail income. Consequently, such income is not subject to Indiana gross retail tax (sales tax). As IC 6-2.5-1-5 instructs:

> "Gross retail income" means the total gross receipts, of any kind or character, received in a retail transaction, *except* that part of the gross receipts attributable to:
>
> > (1) the value of any tangible personal property received in a like kind exchange in the retail transaction;

However, for taxpayer's lease transactions, the trade-in of an owned vehicle for a leased vehicle does not meet the statutory definition of a like kind exchange. A like kind exchange is defined in Indiana Code § 6-2.5-1-6(a) in the following manner:

> "Like kind exchange" means the reciprocal exchange of personal property between two (2) persons, when:
>
> > (1) the property exchanged is of the same kind or character, regardless of grade or quality; and
> >
> > (2) the persons exchanging the property both own the property prior to the exchange.

The trade-ins involved in these lease transactions were not exchanges of property of the "same kind or character." The customer's vehicle trade-in (tangible personal property) was not exchanged for ownership in another vehicle. Rather, it was exchanged for *the lease* of a vehicle owned by another (intangible personal property). Furthermore, the bundle of rights acquired in a lease transaction is not equivalent to that acquired in a purchase agreement. Consequently, the property exchanged is not of the same kind or character.

Additionally, taxpayer argues that a new statute - effective July 1, 1997 - was the Indiana legislature's response to the Department's misapplication of its like kind exchange regulation. This newly enacted statute explicitly exempts from sales tax the value of vehicles exchanged (traded-in) in lease transactions. Taxpayer directs the Department's attention to IC 6-2.5-5-38.2, which states:

> The value of an owned vehicle is exempt from the Indiana gross retail tax in a vehicle lease transaction if the owned vehicle is exchanged for a like kind vehicle.

Taxpayer concludes that this new statutory language should preclude the Department from enforcing Audit's erroneous assessment of Indiana sales tax on the trade-in of vehicles in lease transactions.

The Department notes that absent language stating otherwise, statutes are given prospective treatment. In this instance, the wording of Public Law 253 Section 38 - the law in which Ind. Code § 6-2.5-5-38.2 was enacted - explicitly states that this new section was to take effect on July 1, 1997. The statute, therefore, can not be applied retroactively. Consequently, taxpayer cannot take advantage of the statute's provisions prior to the its effective date – i.e., July 1, 1997.

(2) The Department has “inflated” the value of the trade-in equity to be taxed.

Assuming *arguendo* that taxpayer should have charged sales tax on the net trade equity of the value of the customer’s owned vehicle used as a capital cost reduction in a vehicle lease transaction, taxpayer disputes Audit’s interpretation of “net trade equity. *(Net trade equity is the amount given for the customer’s owned vehicle less any amount owed on the vehicle.)* In other words, taxpayer believes that Audit has overstated the value of the trade-ins. This overstatement, of course, increases the retail price of the leased vehicle as well as the amount of sales tax that should have been collected.

Taxpayer argues that Audit’s method of determining trade-in equity does not allow for the “over allowance” that taxpayer has built into the customer’s trade-in allowance. *(“Over allowance” is the practice of giving more for the customer’s vehicle than it is worth instead of discounting the Manufacturers Suggested Retail Price (“MSRP”).)* Taxpayer believes that when calculating the net trade equity the equity in the customer’s vehicle subject to sales tax should be the “actual cash value” of the vehicle less any amount owed. In summary, taxpayer contends that the trade-in equity should equal "the difference in the 'Actual Cash Value' less payoff allowed [rather than]…the difference in 'trade allowance' less the payoff allowed."

As illustration, taxpayer posits the following scenario. "A customer trades in a vehicle with [an] actual cash value of $5,000, with an over allowance of $1,500. The Manufacturers Suggested Retail Price (the "MSRP") [of the vehicle to be leased] is $25,000." *(Note: over allowance is defined by taxpayer as the value of the trade-in exceeding the actual cash value of the vehicle. In this example, the actual cash value would equal $5,000, while the "trade allowance would equal $6,500 – i.e., the actual cash value plus the over allowance.)*

According to taxpayer, the aforementioned transaction, for taxation purposes, can be characterized in one of two ways. On one hand, the transaction can be viewed as one in which the MSRP ($25,000) is reduced by the trade-in amount ($6,500) resulting in a trade difference of $18,500. Alternately, the transaction can be viewed as one in which the MSRP ($25,000) is first discounted by the over allowance ($1,500) resulting in a new retail price ($23,500). The new retail price then is reduced by the actual cash value of the trade-in ($5,000) which again results in a trade difference of $18,500. Under the first scenario, (and only for those transactions occurring prior to July 1, 1997), the retail price of the leased vehicle would be $25,000 and the entire $6,500 would be taxable – taxable as consideration given towards the lease of a new vehicle. However, under the second scenario, only $5,000 would be subject to tax because the retail price of the leased vehicle would be $23,500. Audit endorses the first scenario, which includes the over allowance in the trade equity computation; taxpayer endorses the latter, which does not.

The Department recognizes that in the context of taxpayer's business valuations of vehicle trade-in allowances, "over allowances" (taxpayer's term-of-art), and ultimately the vehicles selling price are necessarily subjective in nature. **The Department, however, believes that the best evidence of these valuations is contained in the terms of the lease agreements that the dealer (taxpayer) offered to its customers and which were subsequently accepted.** In other words, the parties reached a contractual agreement (i.e., the lease agreement) based on the stated MSRP, any stated deductions from the MSRP (thus reducing the actual selling/lease price), and any stated capital cost reductions as they were documented in the lease agreements.

From the Department's perspective, taxpayer partitions the trade-in allowance given into an "actual cash value" element and an "over allowance" element in order to apportion among its various departments the income and expenses resulting from these lease transactions. **Taxpayer's characterization of the elements of the lease transaction (i.e., the characterization of a portion of the trade-in allowance as an over allowance) for internal accounting purposes does not effect the lease transaction's taxable consequences.** Accordingly, for transactions prior to July 1, 1997, taxpayer should have collected sales tax on all capital cost reductions at the inception of the lease agreement.

FINDINGS

The taxpayer's protest is denied.

II. Tax Administration — Penalty

DISCUSSION

The taxpayer protests the imposition of the ten-percent (10%) penalty. The negligence penalty imposed under IC 6-8.1-10-2.1(e) may be waived by the Department where reasonable cause for the deficiency has been shown by the taxpayer. Specifically:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-2.1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. 45 IAC 15-11-2(e).

The Department notes that for this taxpayer, the taxability of trade-in allowances has not been an issue in prior audits. The Department also recognizes the novelty, at the time of this audit, of vehicle lease transactions, generally - and its taxable consequences, specifically. For these reasons, the Department believes that application of a negligence penalty would be inappropriate.

FINDING

Taxpayer's protest is sustained.

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